[JOINT COMMITTEE PRINT]

BACKGROUND AND ISSUES RELATING TO THE TAX TREATMENT OF SINGLE PREMIUM AND OTHER INVESTMENT-ORIENTED LIFE INSURANCE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of present law, current issues, and possible proposals relating to the tax treatment of single premium and other investment-oriented life insurance.

Part I of the pamphlet contains a description of the various types of life insurance products currently being marketed; it also describes the present-law tax treatment of life insurance to policyholders and life insurance companies and provides a comparison of the tax treatment of other tax-favored forms of savings and investment. Part II of the pamphlet contains an analysis of the tax benefits available from investment-oriented insurance products, followed in Part III by a discussion of the issues relating to the present-law tax treatment. In Part IV of the pamphlet, various proposals (including proposals offered by several industry groups) to modify the tax treatment of life insurance are outlined, and Part V contains a brief analysis of those proposals.

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on March 15, 1988, to consider whether the Federal income tax treatment of life insurance contracts is appropriate under present law. The Subcommittee will analyze the current uses of life insurance policies, particularly single premium policies and other policies marketed primarily as investment vehicles, to consider whether the present-law tax treatment of life insurance is justified in light of these uses. Additionally, the Subcommittee intends to explore proposals to limit the use of life insurance as an investment vehicle without discouraging the purchase of life insurance as a means to provide death benefits for dependents.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Background and Issues Relating to the Tax Treatment of Single Premium and Other Investment-Oriented Life Insurance* (JCS-6-88), March 14, 1988.

I. BACKGROUND AND PRESENT LAW

A. Background

In general

The traditional goal of life insurance has been to protect the policyholder's beneficiaries (usually the policyholder's family) against a loss of income and costs arising from the death of the person whose life was insured. This goal is accomplished by pooling the probable cost of the same types of risk of loss over a large number of policyholders.

In many cases, a life insurance policy will combine two elements—pure insurance protection and an investment component. The investment component (commonly referred to as cash value) arises if the premiums paid by the policyholder in any year (or other policy term), less certain charges and plus credited earnings, exceeds the cost of insurance coverage provided to the policyholder for the year (or term). This buildup of cash value allows the payment, in later years, of premiums that are less than the current cost of the insurance protection.

An overview of the principal types of life insurance products currently being sold follows.

Term insurance

Term insurance is a contract that furnishes life insurance protection for a limited term. The face value of the policy is payable if death occurs during the stipulated term of the contract. Nothing is paid if the individual on whose life the insurance is provided survives to the end of the term. Premium charges only cover the risk of death so little or no cash value builds up over the term of the policy. For any given amount of life insurance, premium charges increase with the policyholder's age because the risk of death (i.e., the mortality charge) is age-related. As a result, term insurance may be impractical as a policyholder ages because the term cost of insurance approaches a significant percentage of the face amount of the policy.

Term insurance policies are most frequently issued for a period of one year, although a term insurance policy may provide protection for a shorter period (such as the duration of a plane flight) or a longer period (such as the life expectancy of an individual). Although term insurance contracts are primarily protection contracts, the leveling of a premium over a long period of years produces a small cash value that increases to a point and then declines to zero at the termination of the contract.

Whole life insurance

In general

A whole life insurance contract provides for the payment of the face value of the policy upon the death of the insured; payment is not contingent upon death occurring within a specified period. Such protection may be purchased under either of two principal types of contract: (1) an ordinary life contract, or (2) a limited payment life contract. The chief difference between the two is the method of premium payments.

The ordinary life contract assumes that premiums will be paid on a level basis throughout the insured's lifetime. In the early years, the annual level premium is in excess of the amount required to pay the current cost of the insurance protection (i.e., the current cost of term insurance in an amount equal to the difference between the face amount of the policy and its cash value). The balance that is retained by the company, at interest, produces a fund which is called the cash value of the policy. This cash value reduces the insurance element in later years when the annual level premium would no longer cover the annual cost of term insurance in the face amount. The cash value accumulation continues until reaching the face value of the policy at maturity (which occurs when the insured reaches a specified age, typically age 95 or 100).

Under the limited payment life contract, premiums are charged for a limited number of years (such as 10 or 20 years). After the premium payment period, the cash value of the policy, together with interest credited, is sufficient to pay the cost of term insurance protection for the remainder of the period that the policy is in effect. The premium under such a contract will be significantly larger than the aggregate amount of premiums paid during the same period under an ordinary life contract so that the company can carry the policy to maturity without further charges.

The insurance element in a whole life policy is the difference between the face amount and the cash value. The cash value that accumulates at interest to maturity of the contract is the investment element in the policy.

Single premium life insurance

The most extreme form of limited payment whole life insurance is single premium life insurance. Under a single premium life insurance contract, a paid-up policy is purchased at policy inception with a single premium payment, or a few initial payments, rather than a longer series of premium payments. Such a policy maximizes the investment element of the policy in the initial years after policy inception. In the case of single premium life insurance, the investment component of the initial premium is so large that no additional premiums need to be paid for insurance coverage. Single premium insurance can also provide the policyholder with a choice of investment vehicles, thus functioning like a mutual fund; such a contract is characterized as variable single premium insurance (see "variable life," below).

Universal life

The savings or investment feature of life insurance is also characteristic of other permanent plans of life insurance, such as universal life. Universal life insurance is a whole life insurance contract that retains the investment and insurance features of traditional life insurance products, while disclosing the charges for insurance and the interest rate credited to the policyholder. Universal life is distinguished from traditional whole life insurance products in that the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates that may change from time to time above a minimum rate guaranteed in the contract.

A universal life insurance policy generally offers the policyholder a basic death benefit equal to (1) a fixed face amount, or (2) the sum of a fixed amount plus the cash value of the policy as of the death of the insured.

In a universal life policy, the investment element is the cash value that accumulates at interest, which interest may be adjusted above a minimum guaranteed rate to reflect market interest rates. As under a traditional whole life insurance policy, the insurance element of a universal life policy is the difference between the prescribed death benefit and the cash value.

Variable life

The distinguishing feature of a variable life insurance policy is that the cash value of the policy effectively is invested in shares of a mutual fund. The cash value reflects the value of assets at the time the cash value is computed. In certain variable life insurance policies, the death benefit may also vary with the value of the underlying investment account.

Premiums under variable life insurance contracts purchase units in a segregated investment account managed by the insurance company and are treated as a security subject to the Securities Act of 1933.

Universal variable life insurance

A universal variable contract provides the policyholder with a choice of funds into which the cash value of the contract can be invested. It also features a flexible arrangement for paying premiums under which the policyholder decides how much to apply to insurance and how much to savings. In addition, the policyholder may change the face amount of the policy and vary the amount and frequency of premium payments. Often, such a policy provides that a guaranteed death benefit will be paid upon the death of the insured, regardless of investment earnings.

B. Present Law

In general

Under a fundamental principle of the Federal income tax, income is subject to tax when it is actually or constructively received. Income is constructively received by a taxpayer if the income is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or could draw upon it if notice of intent to withdraw had been given. Thus, for example, interest income credited to a savings account or money market fund is taxable to the owner of the account or fund when credited.

Special rules have been adopted under which certain income is not taxable at the time it normally would be taxed under general income tax principles. For example, the investment income on amounts contributed (within limits) to an individual retirement arrangement (IRA) generally is not includible in income until withdrawn even though the taxpayer may draw upon the income at any time.

In the case of life insurance, a special rule also applies under which the investment income ("inside buildup") earned on premiums credited under a contract that meets a statutory definition of life insurance generally is not subject to current taxation to the owner of the policy. In addition, death benefits under such a life insurance contract are excluded from the gross income of the recipient (sec. 101(a)), so that neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured.

Distributions from a life insurance contract that are made prior to the death of the insured generally are not includible in income to the extent that the amounts distributed are less than the taxpayer's basis in the contract.

Amounts borrowed under a life insurance contract generally are not treated as distributions from the contract, even if the amounts borrowed are not repaid prior to the death of the insured. Consequently, the inside buildup attributable to amounts borrowed under a life insurance contract is not includible in income even though the policyholder has current use of the inside buildup.

Under present law, a life insurance company generally is not subject to tax on the inside buildup on a life insurance or annuity contract because of the reserve deduction rules applicable to life insurance companies.

Definition of life insurance

In general

Under present law, the favorable tax treatment accorded to life insurance is only available for contracts that satisfy a definition of life insurance that was enacted as part of the Deficit Reduction Act of 1984 (DEFRA). This definition was adopted to limit the permissible investment orientation of life insurance contracts to levels more in line with traditional life insurance products.

A life insurance contract is defined as any contract that is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes. In general, a contract meets the cash value accumulation test if the cash surrender value may not exceed the net single premium that would have to be paid to fund future benefits under the contract. A contract generally meets the guideline premium/cash value corridor test if the premiums paid under the policy do not exceed certain guideline levels, and the death benefit under the policy is not less than a varying statutory percentage of the cash surrender value of the policy.

If a contract does not satisfy the statutory definition of life insurance, the sum of (1) the increase in the cash surrender value and (2) the cost of insurance coverage provided under the contract, over the premiums paid during the year (less any policyholder dividends) is treated as ordinary income received or accrued by the policyholder during the year, and only the excess of the death benefit over the net surrender value of the contract is excludable from the income of the recipient of the death benefit.

Cash value accumulation test

The cash value accumulation test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to qualify as life insurance contracts.

Under this test, the cash surrender value of the contract, by the terms of the contract, may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Thus, this test allows a recomputation of the limitation (the net single premium) at any point in time during the contract period based on the current and future benefits guaranteed under the contract at that time. The term future benefits means death benefits and endowment benefits. The death benefit is the amount that is payable in the event of the death of the insured, without regard to any qualified additional benefits.

Cash surrender value is defined as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and, generally, against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or reasonable termination dividend.

The determination of whether a contract satisfies the cash value accumulation test is made on the basis of the terms of the contract. In making this determination, the net single premium as of any date is computed using a rate of interest that equals an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. The mortality charges taken into account in computing the net single premium are those specified in the contract, or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract.

The amount of any qualified additional benefits is not taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit is treated as a future benefit, thereby increasing the cash value limitation by the discounted value of that charge. Qualified additional benefits include guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the case of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit is taken into account. For example, if a contract provides for business term insurance as an additional benefit, neither the term insurance coverage nor the charge for the insurance is considered a future benefit.

Guideline premium and cash value corridor test requirements

In general.—The second alternative test under which a contract may qualify as a life insurance contract has two requirements: the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts that permit relatively modest investment and relatively modest investment returns.

Guideline premium limitation.—A life insurance contract meets the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract is the premium at issue required to fund future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or, if none are specified, the mortality charges used in determining the statutory reserves for the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the rate or rates guaranteed on the issuance of the contract.

The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract. The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year, but only if the contract would terminate without cash value but for such payment. Also, premiums returned to a policyholder with interest within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income.

Cash value corridor.—A life insurance contract falls within the cash value corridor if the death benefit under the contract at any time is equal to or greater than the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, a life insurance contract that covers an insured person who is 55 years of age at the beginning of a contract year and that has a cash surrender value of $10,000 must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As illustrated by Table 1, the applicable percentage starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage decreases by the same amount for each year in the age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage is 142.

The statutory table of applicable percentages follows:

Table 1.—Cash Value Corridor

In the case of an insured with an attained age as of the beginning of the contract year of—		The applicable percentages shall decrease by a ratable portion for each full year—	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

Computational rules

Present law provides 3 general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These rules restrict the actual provisions and benefits that can be offered in a life insurance contract only to the extent that they restrict the allowable cash surrender value (under the cash value accumulation test) or the allowable funding pattern (under the guideline premium limitation).

First, in computing the net single premium under the cash value accumulation test or the guideline premium limitation under any contract, the death benefit generally is deemed not to increase at any time during the life of the contract (qualified additional benefits are treated in the same way).

Second, irrespective of the maturity date actually set forth in the contract, the maturity date (including the date on which any endowment benefit is payable) is deemed to be no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100.

Third, the amount of any endowment benefit, or the sum of any endowment benefits, is deemed not to exceed the least amount payable as a death benefit at any time under the contract. For these purposes, the term endowment benefits includes the cash surrender value at the maturity date.

Adjustments

Under present law, proper adjustments must be made for any change in the future benefits or any qualified additional benefit (or any other terms) under a life insurance contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of the contract can

occur by an action of the company or the policyholder or by the passage of time.

If there is a change in the benefits under (or in other terms of) the contract that was not reflected in any previous determination or adjustment made under the definitional section, proper adjustments must be made in future determinations under the definition. If the change reduces benefits under the contract, the adjustments may include a required distribution in an amount determined under the adjustment regulations for purposes of enabling the contract to meet the applicable definitional test. A portion of the distribution required by application of the definitional tests is taxed as ordinary income to the extent there is income in the contract.

A portion of the cash distributed to a policyholder as a result of a change in future benefits is treated as being paid first out of income in the contract, rather than as a return of the policyholder's investment in the contract, only if the reduction in future benefits occurs during the 15-year period following the issue date of the contract.

Contracts not meeting the life insurance definition

If a life insurance contract does not meet either of the alternative tests under the definition of a life insurance contract, the income on the contract for any taxable year of the policyholder is treated as ordinary income received or accrued by the policyholder during that year. In addition, the income on the contract for all prior taxable years is treated as received or accrued during the taxable year in which the contract ceases to meet the definition.

For this purpose, the income on a contract is the amount by which the sum of the increase in the net surrender value of the contract during the taxable year and the cost of life insurance protection provided during the year under the contract exceed the amount of premiums paid less any policyholder dividends paid under the contract during the taxable year. The cost of life insurance protection provided under any contract is the lesser of the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums, computed using 5-year age brackets, or the mortality charge stated in the contract.

Only the excess of the amount of death benefit paid over the net surrender value of the contract is treated as paid under a life insurance contract for purposes of the exclusion from income of the beneficiary.

If a life insurance contract fails to meet the tests in the definition, it nonetheless is treated as an insurance contract for other tax purposes. This insures that the premiums and income credited to failing policies is taken into account by the insurance company in computing its taxable income. In addition, it insures that a company that issues failing policies continues to qualify as an insurance company.

Treatment of inside buildup

The investment component of a life insurance premium is the portion of the premium not used to pay the pure insurance costs (including the operating, administrative, overhead charges, and profit of the company). This amount, which is added to the cash

value of the policy, may be considered comparable to an interest-bearing savings deposit. The cash value of the life insurance is credited with interest. This amount of interest is called the inside buildup, and under present law it is not taxed as current income of the policyholder.

In many circumstances, the investment income credited to the account of the policyholder is never taxed. For example, the proceeds of the policy paid upon the death of the insured (including investment income credited to the policy) are excluded from the beneficiary's income (sec. 101). Further, the proceeds of life insurance may be excluded from the gross estate of the insured (sec. 2042).

Under other circumstances, a portion of the investment income earned may be subject to tax. For example, if a policy is cashed in (or surrendered) in exchange for its cash surrender value, or if distributions are made in some other fashion, these amounts are taxed as ordinary income to the extent that the cumulative amount paid exceeds the policyholder's basis (i.e., the investment in the contract (secs. 72(e)(5)(A) and 72(e)(6))). The investment in the contract is the difference between the total amount of premiums paid under the contract and the amount previously received under the contract that was excludable from gross income. Under these rules, the portion of investment income that was used to pay for term insurance protection is not subject to tax.

Partial surrenders of a life insurance contract that are made prior to the death of the insured generally are not includible in income to the extent that the amounts distributed are less than the taxpayer's basis in the contract.

The investment income under a life insurance contract may be subject to tax in certain other instances. Under present law, no gain or loss generally is recognized on the exchange of a contract of life insurance for another contract of life insurance. However, any cash that a policyholder receives as a result of an exchange of policies is subject to tax to the extent that there is income in the contract.

Borrowing under life insurance contracts

The inside buildup on a life insurance contract generally is not treated as distributed to the policyholder if the policyholder borrows under the policy, even though the policyholder has current use of the money. Consequently, the inside buildup under a life insurance contract is not taxed at the time of a policyholder loan.

Under present law, interest on amounts borrowed under a life insurance policy for personal expenditures is treated as nondeductible personal interest (subject to a phase-in rule for taxable years beginning in 1987 through 1990). Present law also treats as nondeductible the interest on debt with respect to policies covering the life of an officer or employee of, or individual financially interested in, a trade or business carried on by a taxpayer (to the extent the debt exceeds $50,000 per officer, employee, or individual).

Policyholder loans at low or no net interest rates are not specifically subject to the below-market loan rules under present law.

Comparison of tax-favored forms of investment

In general, the tax treatment of cash value (whole) life insurance contracts compares favorably with the tax treatment of other tax-favored forms of investment under present law. Tax incentives are used to encourage retirement savings through deferred annuity contracts, individual retirement arrangements (IRAs), and qualified pension plans (including qualified cash or deferred arrangements (401(k) plans) and Keogh plans (for self-employed individuals)).

Under present law, limits are imposed on contributions to qualified pension plans and IRAs, without regard to whether the contributions to such plans are deductible or nondeductible. On the other hand, contributions to deferred annuity contracts and life insurance contributions, which are always nondeductible, are not limited.

Special rules apply under present law to prevent the use of qualified pension plans, IRAs, and deferred annuities for nonretirement purposes. Under these rules, any distribution from a qualified plan or IRA is treated as a pro rata recovery of income and basis. Under a deferred annuity, distributions prior to the annuity starting date are treated as income first and then as a nontaxable recovery of basis. In addition, under qualified plans, IRAs, and deferred annuities, an additional 10-percent income tax is imposed on income attributable to distributions that occur prior to the attainment of age 59-1/2, death, disability, annuitization, and certain other events. This additional tax is intended to recapture partially the tax benefits of deferral when tax-favored savings are not used for their intended purposes. In the case of whole life insurance, partial surrenders and other pre-death distributions are treated first as a return of basis. Additionally, the 10-percent early withdrawal tax does not apply to life insurance contracts.

The present-law tax rules for qualified plans allow the favorable tax treatment only if the plan complies with nondiscrimination rules intended to ensure that the favorable tax treatment does not disproportionately favor highly compensated individuals. Similarly, the most favorable tax treatment of IRAs (deductibility of contributions) is disallowed for married taxpayers with adjusted gross income above $50,000 (if either spouse is an active participant in a qualified pension plan). On the other hand, favorable tax treatment of deferred annuities and whole life insurance is not conditioned on the income level of the taxpayer.

Further, in the case of most tax-favored forms of investment, present law provides restrictions on borrowing to prevent current use of tax-deferred income. Thus, in the case of deferred annuities, loans generally are treated as taxable distributions. In the case of qualified pension plans, loans in excess of the lesser of $50,000 or 50 percent of the individual's accrued benefit generally are treated as taxable distributions. No borrowing is permitted from an IRA. By contrast, no limitations currently apply to borrowing from a whole life insurance contract, other than restrictions on interest deductions on loans by nonindividual holders of such contracts.

Finally, the favorable tax treatment for IRAs, qualified plans, and deferred annuities is restricted to the situation in which an individual is the owner or ultimate beneficiary of the investment. In

the case of whole life insurance, however, the favorable tax treatment is also allowed for corporate owners or beneficiaries.

Table 2 shows the comparative treatment of these various forms of investment under present law.

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Table 2.—Comparison of Present Law for Various Tax-Favored Savings Arrangements

	Life Insurance	IRA's	401(k) Plans	Qualified Pension Plans (including Keogh Plans)	Deferred Annuities
Limits on contributions	None	The maximum contribution for a year is $2,000 (including both deductible and nondeductible amounts).	The maximum elective contribution for a year is $7,000.	The maximum annual contribution on behalf of an individual to a defined contribution plan cannot exceed the lesser of (1) $30,000 or (2) 25 percent of the individual's compensation.	None, but corporate holders of deferred annuities are taxed currently on the inside buildup on the contract.
Early withdrawal tax	None	A 10-percent additional income tax applies to distributions from an IRA other than distributions— (1) after the IRA owner attains 59½, (2) after the death of the IRA owner, (3) due to the disability of the IRA owner, or (4) which are part of a series of substantially equal payments for the life (or life expectancy) of the IRA owner or joint lives (or joint life expectancies) of the IRA owner and his beneficiary.	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) made after separation from service after age 55, (2) made from an ESOP, (3) to the extent the distribution does not exceed the amount allowable as a deduction for medical expenses, or (4) made to an alternate payee pursuant to a qualified domestic relations order.	Same as 401(k) plans	Same as IRAs, except that (in addition to the exceptions from the tax for IRAs), the tax also does not apply to distributions— (1) from qualified plans, IRAs, and certain contracts purchased by qualified plans or certain other types of plans, (2) allocable to investment in the contract before August 14, 1982, (3) under a qualified funding asset that is part of a structured settlement agreement, (4) under an immediate annuity contract, or (5) which is purchased by an employer upon termination of a qualified pension plan.

Treatment of loans	Loans permitted and not treated as distributions.	Not permitted	Loans treated as distributions to the extent they exceed the lesser of— (1) $50,000 or (2) ½ of the participant's account balance	Same as 401(k) plans	Loans treated as distributions.
Basis recovery	Distributions prior to the death of the insured are treated as a return of the investment in the contract (i.e., basis first).	With respect to amounts received prior to the annuity starting date and annuity distributions, a portion of each distribution is nontaxable in the same proportion as the taxpayer's basis is to the total account balance.	Same as the IRA rules	Same as the IRA rules	Distributions prior to the annuity starting date are treated as income first.
Benefits restricted to individual (e.g., noncorporate) owners.	No	Yes	Yes	Yes	Yes.

Tax treatment of insurance companies

Under present law, a life insurance company generally is not subject to tax on the inside buildup on a life insurance or annuity contract because of the life insurance company reserve rules. Under these rules, a life insurance company is allowed a deduction for a net increase in life insurance reserves (taking into account both premiums and assumed interest credited to the reserves) and must take into income any net decrease in reserves. The net increase (or net decrease) in reserves is computed by comparing the closing balance to the opening balance for reserves in the same year. Life insurance reserves are defined to include amounts set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity and noncancellable accident and health insurance contracts that involve life, accident, or health contingencies at the time with respect to which the reserve is computed.

The maximum reserve permitted under present law with respect to a contract equals the greater of (1) the net surrender value of the contract or (2) the Federally prescribed tax reserve. In computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used along with the prevailing National Association of Insurance Commissioners ("NAIC") standard tables for mortality or morbidity. The assumed interest rate to be used to discount future obligations in computing the Federally prescribed reserve generally equals the greater of (1) the prevailing State assumed interest rate (generally, the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type) or (2) the average applicable Federal rate (AFR) of interest (specifically, the average of the applicable Federal mid-term rates for the most recent 60-month period beginning after July 1986).

Present law does not treat reserve deductions of insurance companies as a specific item of tax preference under the corporate alternative minimum tax.

II. ANALYSIS OF TAX BENEFITS FROM INVESTMENT-ORIENTED LIFE INSURANCE PRODUCTS

Cash value insurance

Under cash value (whole life) insurance, premiums in the initial years after policy issuance exceed premiums for term insurance providing an equivalent death benefit. The excess premium is invested and is credited, along with earnings, to the policyholder's cash surrender value. In the event of the policyholder's death, the cash surrender value is used to pay a portion of the death benefit. Consequently, as the cash value grows over time, it pays an increasing portion of the death benefit and reduces the mortality charge on the contract. Thus, unlike term insurance, which has no investment component, the premiums on a cash value contract do not rise with the policyholder's age. In single premium life, the investment component of the initial premium is so large that no additional premiums need to be paid for insurance coverage.

Table 3 compares term, ordinary (level premium), and single premium life insurance for a $100,000 policy acquired by a 55 year old male. Premiums and cash value are computed before loading charges using the 1980 Commissioner's Standard Ordinary ("CSO") mortality table and a 6-percent interest rate. At age 55, the premium for term insurance is $988. By comparison, the premium for ordinary life insurance is $2,792, and for single premium life insurance is $33,034. The excess of these premiums over the cost of term insurance is invested and is credited, along with earnings, to the policy's cash value.

Table 3.—Term, Ordinary, and Single Premium Insurance [1]

[$100,000 death benefit, male age 55, 6-percent interest rate, net of loading charges]

Age of policyholder	Term insurance		Ordinary life		Single premium	
	Premium	Cash value	Premium	Cash value	Premium	Cash value
55	$988	0	$2,792	$1,933	$33,034	$34,328
60	1,517	0	2,792	12,258	0	41,243
65	2,398	0	2,792	23,494	0	48,767
70	3,727	0	2,792	35,180	0	56,592
75	6,056	0	2,792	46,671	0	64,288

[1] Assumes 100 percent of 1980 CSO mortality, 6-percent interest rate, ordinary life paid up at age 100, premiums paid at beginning of year, and death benefits paid at end of year.

Preferential tax treatment of cash value life insurance

The investment component of cash value life insurance receives preferential tax treatment compared to other similar investments such as mutual funds, certificates of deposit, and savings accounts. Income credited on such investments is included currently in the investor's taxable income. By contrast, the investment income credited to a policyholder under a life insurance contract (referred to as "inside buildup") is not included currently in the policyholder's taxable income. Moreover, the inside buildup on the contract may be withdrawn tax-free as a loan, dividend, or partial surrender up to the amount of premiums paid. Finally, benefits paid at death generally are excluded from income. Thus, unlike other investments, life insurance policies allow deferral of tax on investment income, and if the policy is held to death, income tax may be avoided completely.

The preferential tax treatment of life insurance can be measured by comparing the policyholder's tax liability on income earned under the contract to that of an individual who invests the cash value in a mutual fund with the same earnings rate. Table 4 compares, for a 55 year old male in the 28-percent tax bracket, the cash value that would accumulate by age 75 in a life insurance policy as compared to a mutual fund, both yielding 6 percent per annum before tax.

For purposes of comparison, it is assumed that the amount invested in the mutual fund is equal to the premiums paid on each of four different insurance policies: an ordinary life policy and three types of single premium policies. The first single premium policy, the "standard" contract, is designed to have the lowest possible premium and thus the least inside buildup. The other two single premium policies shown in Table 4 are more investment oriented—they are designed to approximate the largest amount of inside buildup allowable under either the cash value accumulation test or the guideline premium cash value corridor test specified in Code section 7702.[3] In the most investment-oriented single premium policies, stated charges for mortality and expenses are larger than the insurance company anticipates based on experience: this inflation of mortality and expense charges allows the insurance company to offer more inside buildup than otherwise would be the case under the cash value accumulation and guideline premium tests. To reflect market practice, the investment-oriented single premium contracts shown in Table 4 are assumed to state mortality charges of 600 percent of 1980 CSO. (For computing cash value, 100 percent of 1980 CSO is assumed).

[3] Both policies have an initial death benefit of $100,000. To meet the cash value accumulation and guideline premium tests, the death benefit is increased as necessary.

Table 4.—Comparison of Life Insurance and Mutual Fund Investments [1]

[$100,000 initial death benefit, male age 55, 6-percent interest rate, net of loading charges]

Item	Ordinary life policy	Single premium policy [2]		
		Standard policy	Cash value accum. policy	Guide-line premium policy
Premium or investment	[3] $2,792	$33,034	$68,401	$62,570
Insurance policy alternative:				
Cash value age 75	$46,671	$64,288	$209,301	$191,165
Tax on surrender	$0	$8,751	$39,452	$36,007
After-tax value	$46,671	$55,537	$169,849	$155,159
Mutual fund alternative: [4]				
Cash value age 75	$96,463	$80,293	$166,258	$152,085
After-tax value of insurance as a percent of mutual fund investment	48.4	69.2	102.2	102.0

[1] For computing cash value, assumes 100 percent of 1980 CSO, 6-percent interest rate, premiums paid at beginning of year, and death benefits paid at end of year. Policyholder is in 28-percent tax bracket and after-tax discount rate is 4.32 percent (6 percent net of 28 percent tax).

[2] Contract states mortality charge of 600 percent of 1980 CSO.

[3] Annual premium; cumulative premiums to age 75 are $58,637.

[4] Insurance premiums invested in mutual fund earning 6 percent before tax (4.32 percent after tax).

Table 4 shows that the cash value in an ordinary life policy grows to $46,671 at age 75 as compared to $96,463 if the premiums were invested in a mutual fund. The cash value in a standard single premium policy grows by age 75 to $64,288 before tax and $55,537 after tax, as compared to $80,293 if the premiums were invested in a mutual fund. Thus, an investor would not purchase either of these insurance policies unless the investor wanted life insurance protection. By comparison, Table 4 shows that for more investment-oriented single premium products, the after-tax cash value at age 75 exceeds the value of investing the premiums in a mutual fund by approximately 2 percent. Thus, an individual would purchase an investment-oriented single premium life insurance contract even if the individual was indifferent about purchasing life insurance protection because the value of investing in the single premium policy exceeds the value of investing in a mutual fund even after mortality charges for insurance protection.

Another way to analyze the preferential tax treatment of life insurance is to compare a policyholder's tax liability under present law with what tax liability would have been if inside buildup were subject to tax in the year earned. The difference in tax liability is the benefit the policyholder obtains from the preferential tax treatment of life insurance. The tax benefit may be compared with the

value of life insurance coverage purchased. The value of life insurance coverage is the cost of term insurance for the amount of the death benefit not paid for out of the policyholder's cash surrender value. The value of tax benefits relative to the value of life insurance coverage in a policy is a measure of the extent to which the tax system subsidizes the purchase of life insurance protection.

Table 5 illustrates that the present value of tax benefits on a life insurance policy increases the longer the contract is held because the tax on inside buildup is deferred for a longer period of time. For example, for a $100,000 ordinary life insurance policy acquired by a 55 year old male, the present value of tax benefits increases from $556, if the policy is surrendered at age 60, to $4,395 if the policy is surrendered at age 75. If the policy is held until death, which is presumed to occur at age 76 (the life expectancy of a 55 year-old male), the value of tax benefits is $4,700.

As a percent of the value of insurance coverage purchased, the value of tax benefits on the ordinary life insurance contract increases from 9.0 percent at age 60 to 17.7 percent at age 75, and is 17.9 percent at death. Thus, in the typical ordinary life insurance policy purchased at age 55, the tax subsidy is a relatively small portion (less than 20 percent) of the cost of the insurance coverage purchased.

For a standard single premium policy, the value of tax benefits relative to the value of insurance coverage rises from 31.7 percent after 5 years to 38.9 percent after 20 years, and is 59.6 percent at death. For more investment-oriented single premium products, the value of tax benefits is a much higher percentage of the insurance coverage purchased. For the investment-oriented single premium policies shown in Table 5, the value of tax benefits is about 100 percent of the value of insurance coverage purchased after 15 years, and is over 300 percent of the value of insurance coverage at death.

Table 5.—Present Value of Insurance Policy Tax Benefit [1]

[$100,000 initial death benefit, male age 55, 6-percent interest rate, net of loading charges]

Age	Present value of tax benefit: policy held to indicated age				Value of tax benefit as a percent of value of insurance coverage			
	Ordinary life policy	Single premium policy [2]			Ordinary life policy	Single premium policy [2]		
		Standard policy	Cash value accum. policy	Guideline premium policy		Standard policy	Cash value accum. policy	Guideline premium policy
60	$556	$1,306	$1,094	$1,076	9.0	31.7	60.6	54.4
65	1,574	2,796	3,098	2,901	13.2	35.1	85.8	78.8
70	2,904	4,551	5,968	5,522	16.0	37.4	104.4	96.9
75	4,395	6,477	9,601	8,689	17.7	38.9	118.2	117.0
76 [3] ..	4,700	10,487	27,210	24,765	17.9	59.6	314.7	321.6

[1] For computing cash value, assumes 100 percent of 1980 CSO, 6-percent interest rate, premiums paid at beginning of year, and death benefits paid at end of year. Assumes policyholder is in 28-percent tax bracket and after-tax discount rate is 4.32 percent (6 percent net of 28 percent tax).

[2] In both the cash value accumulation and the guideline premium policies, the mortality stated in contract is 600 percent of 1980 CSO.

[3] Death assumed to occur at age 76, which is the life expectancy of a male age 55 under the 1980 CSO table.

This analysis illustrates that under present law it is possible to design single premium policies that provide tax benefits to the policyholder that are larger than the value of the insurance coverage purchased. In these situations, single premium life insurance may be purchased exclusively as a tax-advantaged investment even if the policyholder does not need or want life insurance coverage. One case where this is likely to occur is where the insurance contract states higher mortality and other expenses than the life insurance company actually charges. This allows the insurance company to offer more tax-deferred inside buildup than otherwise would be the case under the tax rules adopted in 1984 (sec. 7702).

III. TAX POLICY ISSUES

A. Overview

In recent years, single premium life insurance and other forms of life insurance, such as universal life, variable life, and variable universal life, have been marketed as a tax-sheltered investment vehicle. For example, universal life insurance has been described as having "earned its place in the list of portfolio alternatives. . . [as] a permanently tax-sheltered vehicle, offering attractive leverage at death with the essential risk element centered on fluctuating interest rates."[4]

Another article suggests that tax-shelter advisors:

> should sell single-premium policies by emphasizing the investment side. The avoidance of current taxation makes SPLs [single premium life] more attractive than CDs or Treasuries . . . Today's SPL policies can provide minimum guaranteed returns roughly comparable to long-term municipal bonds or, for more aggressive clients, returns comparable to mutual funds . . . Single premium variable life offers the growth potential of mutual funds, without current taxation. The best prospects for SPL products are high-bracket investors who want tax-advantaged, long-term savings with an insurance kicker.[5]

A third article indicates that investors and their advisors should "[k]eep in mind that this [single premium life insurance] is basically an investment and secondarily a life insurance policy. If your main concern is insurance coverage, then look to straight insurance." [6]

Life insurance companies frequently market single premium life insurance policies on the basis of favorable tax rules for loans. One company states in its materials:

> THE STORY OF SPL: TAX-DEFERRED INTEREST THAT GIVES YOU TAX-FREE PAYMENTS FOR LIFE
>
> Your first SPL premium will be your last. Immediately, it buys a lifetime of insurance with an initial face amount many times larger than your one and only premium. And immediately you'll start to get some tax benefits you may not even know existed.

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[4] Howard I. Saks, "Single Premium Universal Life Draws Attention as Interest Rates Plummet," 12 *Estate Planning* 308, 310 (September 1985). See, also, "Firms Offering 'Universal Life' in Benefit Plans," *The Wall Street Journal*, 31 (May 9, 1985).

[5] Michael L. Markey, "Single-Premium Life is the Ideal Product for Clients Seeking Investment—With a Life Insurance Kicker," *The Stanger Register*, July 1987.

[6] "Nancy Dunnan, "Insure a Tax Break in 1987," *American Bar Association Journal*, May 1987.

You see, life insurance is a uniquely tax-advantaged financial product.

Your SPL begins immediately to earn tax-deferred interest at current, competitive rates . . .

And, on the first anniversary of your owning an SPL, you may borrow your accumulated interest tax-free to use any way you choose . . . because the proceeds of life insurance policy loans are not subject to federal income tax.

A ZERO INTEREST LOAN

What's more, since . . . keeps paying you high, tax-deferred interest credits on the total amount of your borrowed values, your loan costs you nothing . . .

There you have it: policy loans that put income tax-free money into your pocket and reduce the estate value of your life insurance only by the amount of the loans themselves plus interest.

The success of increased marketing of single premium life insurance is reflected by the sales growth of such policies. Table 6 compares the growth in single premium life insurance sales with the growth of other whole life insurance sales. The volume of single premium life insurance sold has increased more than 800 percent since 1984, while the volume of all other whole life insurance sold has increased only 23 percent.

Table 6.—Annual Growth in Single Premium Life Insurance vs. First Year Premiums for Whole Life Insurance (Excluding Single Premium)

[Dollars amounts in billions]

Year	Single premium		Other whole life	
	Amount	Percent growth	Amount	Percent growth
1984	$1.0	.....	$8.3	.....
1985	2.5	150	9.5	14
1986	4.9	96	9.3	−2
1987 [1]	9.5	94	10.1	9

[1] Preliminary.
Source: Life Insurance Marketing and Research Association, Inc.

The growth in the volume of single premium life insurance sold presents issues relating to the purpose for, and the effectiveness of, the favorable tax treatment provided life insurance products. An analysis of the principal tax policy issues follows.

B. Analysis of Specific Tax Policy Issues

1. Is the favorable tax treatment of life insurance justified?

A central issue in assessing the present-law tax treatment of life insurance products is the appropriateness of excluding from income the inside buildup on life insurance policies. Even though a policyholder may have use of amounts earned inside a life insurance policy through loans or partial surrenders, the inside buildup generally is not subject to tax. Further, the tax treatment of life insurance is inconsistent with the tax treatment of other investments, such as bank certificates of deposit or mutual funds. The tax treatment of life insurance is also inconsistent (i.e., significantly more favorable with respect to contribution limits, loans, and distributions) with the treatment of tax/favored retirement investment arrangements, such as IRAs, qualified pension plans (including Keogh plans, qualified cash or deferred arrangements (401(k) plans)), and deferred annuities.

The present-law tax treatment permitting deferral of tax (and, sometimes, exemption from tax) of the inside buildup on life insurance contracts in effect allows taxpayers to purchase life insurance protection with the investment income on the contract that is not currently subject to tax. This tax treatment operates as an incentive for taxpayers to provide adequate economic protection against untimely death. It may also operate as an incentive for saving.

The incentive to protect against untimely death reflects a social policy goal, implemented indirectly through the tax law, to encourage individuals to provide for their families' financial security outside of formal Government programs such as social security and in addition to the private pension system (for which tax incentives are also provided). For example, a situation in which private pension or retirement-related benefits would not provide financial security could occur when a wage-earner dies suddenly before retirement age and the principal short-term source of funds for the dependents of the wage-earner is the proceeds of a life insurance policy.

Various types of life insurance policies can provide the same death benefit and, thus, the same protection for dependents, with differing levels of tax benefits due to the different rates at which tax-free inside buildup accumulates under each type of policy (see Table 5 above). Present law provides a larger tax incentive with respect to single premium life insurance as compared to ordinary life insurance, and no incentive with respect to term insurance.

If, as a social policy goal, it is determined that investment income should not be taxed to the extent used to purchase insurance protection, then it may be argued that other forms of investment income should not be taxed to the extent used to purchase insurance protection. Under this analysis, taxpayers should be provided a tax benefit if other investment income, such as income on a savings account, is used to purchase term insurance protection. Also, if individuals may purchase additional insurance protection with the previously untaxed investment income of a whole life insurance policy, then arguably taxpayers should be allowed to deduct all or a portion of the cost of term insurance.

Under present law, the owner of a bank certificate of deposit is subject to tax on the interest income credited annually to the certificate. The same tax treatment applies to certain other forms of investment, the income on which is reinvested (e.g., the purchase of additional shares in a mutual fund). In addition, interest on zero coupon bonds (and other types of original issue discount obligations) accrues for tax purposes as it is earned, even though it is not actually credited to an account for the owner. Taxing the inside buildup of life insurance policies would make life insurance equivalent for tax purposes to other investments and would reduce a competitive advantage provided to life insurance companies that market life insurance as an investment, rather than as economic protection in the event of death.

On the other hand, some may argue that analogizing life insurance to certificates of deposit or mutual funds fails to recognize the character and importance of permanent life insurance. There are two components to this argument. First, it is argued that the purchase of whole life insurance is similar to the purchase of a home or other capital asset. The appreciation in value of the home or other asset is not taxed until the asset is sold.

This rationale may apply in situations in which the policyholder cannot borrow or otherwise use the earnings on the policy (by assigning or pledging the policy, for example), but is more tenuous in the usual case in which the cash value of the policy can be borrowed. Life insurance products (other than pure term insurance) have a significant savings component that is comparable in many respects to other financial products. Other financial products generally do not receive the same tax-favored treatment (i.e., exclusion or at least deferral of tax on earnings for both the owner of the asset and the financial intermediary providing it) that life insurance products receive under present law. Thus, to the extent of the similarity in structure and use between life insurance products and other financial products, an argument can be made that it is unfair to exclude inside buildup while taxing income on comparable products, and the rationale for the exclusion for inside buildup is weakened.

Second, it is argued that only whole life insurance can provide long-term, systematic savings that ensure adequate death benefit protection. Term insurance cannot provide equivalent long-term security for the average taxpayer because the term cost of insurance becomes prohibitively expensive for older policyholders. Only a permanent program of insurance, it is argued, can build sufficient cash value in the early years after policy issuance to cover the term cost of insurance protection in later years.

2. Is the investment orientation of life insurance limited sufficiently by the definition of life insurance adopted in the Deficit Reduction Act of 1984 (DEFRA)?

The definition of life insurance added by DEFRA was intended to reduce the investment orientation of whole life insurance policies. In the years before DEFRA, companies began emphasizing investment-oriented products that maximized tax deferral. When compared to traditional life insurance products, these policies offered

greater initial investments or higher investment returns. In response, DEFRA provided a definition of life insurance that treated as currently taxable investments those life insurance policies that provide for much larger investments or buildups of cash value than traditional insurance products.

However, the definition of life insurance adopted in DEFRA does not limit permissible policies to those that provide a premium payment pattern consistent with traditional forms of life insurance, such as a level premium pattern that continues until the maturity date of the contract. DEFRA allows tax deferred growth for single premium policies as long as the investment component of the policy does not exceed certain parameters set forth in the definition. For the more investment-oriented single premium policies on the market currently, present law provides a tax subsidy that is more than 100 percent of the value of the life insurance coverage purchased (see Table 5 above).

A basic issue is whether this level of tax-favored investment is justified. The present-law definition of life insurance encourages purchase of single premium life insurance policies by higher income taxpayers with sufficient disposable income to afford such single premium contracts. Such a definition provides a greater tax benefit to high income taxpayers and, as such, creates inequities within the Federal income tax system.

Further, it can be argued that the definition of life insurance should be tightened in order to ensure that life insurance is purchased for death benefit protection and not as an alternative to taxable forms of investment. Such a tightening of the definition of life insurance would reduce the competitive advantage accorded to life insurance companies over other financial intermediaries under present law and would limit the marketing of life insurance as a tax-favored form of investment.

Life insurance companies point out that purchases of single premium life insurance are not limited exclusively to high income taxpayers and that companies permit the purchase of single premium policies with relatively low levels of initial investment. Taxpayers may have other available assets, such as lump-sum distributions from qualified pension plans, that they wish to use for investment in life insurance.

It may be appropriate to review the mechanics of the present-law definition of life insurance for possible abuses even if the fundamental basis for the DEFRA definition of life insurance is determined to be sound. For example, it may be appropriate to provide that the mortality charges that can be used in calculating whether a policy satisfies the definition of life insurance must be the amounts actually charged by the insurer for that policy to prevent artificial increases in the allowable cash surrender value.

Similarly, it may be appropriate to conform the determination of a policyholder's basis for calculating gain in the policy to the determination of basis for calculating loss.

3. Is access to funds and noninsurance use of inside buildup consistent with the favorable tax treatment provided under present law?

It can be argued that whole life insurance and similar products with cash value (and hence an inside buildup component) do not achieve their intended purposes under present law because the amount of the cash value can be borrowed or otherwise withdrawn for other purposes during the insured person's lifetime, and is consequently not available to be paid as a death benefit. Thus, one could argue that the favorable tax treatment accorded to the inside buildup of a life insurance policy is justified only if the policy is used for its intended, tax-favored purpose and is not justified if the policyholder uses inside buildup directly (through partial surrenders) or indirectly (through loans) for other purposes, such as short-term investment. Under present law, policyholders receive the benefit of tax deferred inside buildup even though the amount set aside to fund a death benefit is reduced through loans or partial surrenders.

On the other hand, restrictions on the use of, or accessibility to, the inside buildup of a life insurance policy may deter investments in such policies and, therefore, may reduce the effectiveness of the tax incentives created to promote the social policy of providing for dependents financially after death.

If the main purpose for the favorable treatment of inside buildup is to provide financial security to dependents upon the death of an insured, then a more directly effective incentive may be to encourage the purchase of insurance products without cash value (i.e., term insurance) so that the death benefit would always be available during the period of coverage. Term insurance may also be more directly related to this purpose than whole life insurance in that coverage could cease once retirement benefits become available to the insured person.

An argument could be made that withdrawals from life insurance policies should be permitted for other socially meritorious expenditures (e.g., tuition costs) on a tax-free or at least tax-deferred basis. For example, although the exclusion for inside buildup may not initially have been intended to be used as a tax-free financing vehicle for college tuition and other educational expenses, its use as such is not inconsistent with the social policy to encourage education and, thus, such a use of life insurance should continue to be permitted.

This reasoning could nevertheless be criticized because college tuition is generally not a deductible or otherwise tax-favored expenditure when paid directly, and to treat it more favorably when funded indirectly through life insurance merely encourages complex transactions, raises form over substance, and primarily benefits the well-advised with capital to set aside. Further, the exclusion for inside buildup is not targeted to such purposes under present law, and this use of life insurance was perhaps not an intended consequence of the exclusion.

4. Should the treatment of contributions, distributions, and loans with respect to life insurance be more consistent with the treatment of tax-favored retirement arrangements?

Present law provides deferral of taxation on investment income earned under certain types of retirement arrangements such as IRAs, qualified pension plans, and deferred annuities (see Table 2, above). These arrangements, however, are subject to numerous restrictions generally designed to ensure that the tax benefit of deferral is targeted to the intended purpose, i.e., to create an incentive for saving for post-retirement periods when wage-earners' income normally decreases significantly. Among the restrictions imposed on such retirement arrangements are: (1) restrictions on the amount that can be contributed to fund tax-deferred earnings; (2) prohibition or current taxation of loans; and (3) current taxation of tax-deferred earnings that are distributed (including additional taxes to take account of the deferral period in the case of early distributions).

Contributions, distributions, and loans with respect to life insurance products are not subject to these types of limitations under present law. It can be argued, however, that to the extent that the purpose of permitting tax-free inside buildup is related or comparable to the purpose for providing tax-deferred earnings for retirement arrangements, similar restrictions ought to apply.

The purpose of encouraging people to provide death benefits for their dependents would be better served if there were disincentives to use the cash value of life insurance for other purposes. Thus, it could be argued that withdrawals and loans—which have the effect of reducing the death benefit available to the beneficiary—should not continue to receive tax-favored treatment, but should be subject to current taxation for the same reason that withdrawals and loans from retirement plans and deferred annuities are taxed. Under this theory, it can be argued that loans under life insurance policies should be treated as distributions, and that distributions should not be treated as made first from basis.

A counterargument would be that the purpose to provide death benefits is not sufficiently similar to the purpose to encourage the provision of retirement benefits, and that, therefore, the treatment of loans and distributions from retirement vehicles is not appropriate in the case of life insurance. As a consequence, the present-law tax-favored treatment of earnings on life insurance contracts should be continued even if the taxpayer has current use of the funds.

Drawing a further analogy between life insurance and tax-favored retirement vehicles, it could be argued that limits should be placed on the amount that can be contributed to fund death benefits on a tax-favored basis, similar to the contribution limits under retirement vehicles. Such a restriction would inhibit the use of life insurance principally as a savings mechanism for current expenditures of the policyholder that may be unrelated to death benefits, and would tend to target the earnings on the life insurance contract to pay death benefits.

Applying contribution limits to life insurance contracts may be criticized on the grounds that it unreasonably limits the amount of the death benefit that individuals may wish to provide for their dependents.

5. Is the present-law tax treatment of life insurance companies appropriate?

Several arguments support the present-law tax treatment of inside buildup on life insurance policies at the company level. First, it can be argued that it is appropriate to allow reserve deductions for increases in cash value representing inside buildup on life insurance policies, because the cash value approximates the value of the company's current obligation to policyholders. Because the company includes the premium in income as it is received, even though the benefit is to be paid far in the future (as actuarially determined), income and deductions are better matched in time, from a cash flow perspective, if the company can amortize its deduction for the future benefit payment.

This accounting treatment for future liabilities differs from normal accrual method accounting for tax purposes. Thus, it can be argued that it is not appropriate to permit life insurance companies, but not other taxpayers, a deduction for a future liability that has not yet accrued (under the standard "all events" test) and with respect to which there has not been economic performance (within the meaning of section 461(h)).

This argument acquires additional force in light of the exclusion for the inside buildup at the policyholder level. The overall result is that in many cases the inside buildup on the policy is never taxed to the policyholder or the beneficiary, or the life insurance company. Such a result may exceed the tax benefit necessary to encourage the provision of death benefits for dependents.

Nevertheless, the fact that inside buildup is not subject to current taxation at the company level is supported by the argument that the earnings do not really belong to the company. Under this argument, the company, as any other financial intermediary, is merely holding and accumulating the funds on behalf of the policyholder and the beneficiary. Thus, it is appropriate that the company not be taxed on income that ultimately belongs to someone else.

This argument ignores the fact that, in many cases, the inside buildup is never taxed to anyone. Thus, it could be argued that taxing the inside buildup at the company level would serve as a proxy for taxing the inside buildup at the policyholder or beneficiary level.

IV. PROPOSALS TO RESTRICT THE USE OF LIFE INSURANCE AS AN INVESTMENT VEHICLE

A. Policyholder Proposals

1. Treatment of inside buildup under life insurance contracts

Impose current taxation of inside buildup on all newly issued life insurance contracts

As set forth in the President's 1985 tax reform proposals,[12] the inside buildup on all newly issued life insurance policies could be currently taxed to the policyholder. Under this proposal, the policyholder would include in income for any taxable year any increase during the year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. Special rules could be provided for variable life insurance contracts in order to prevent taxation of the unrealized appreciation of assets underlying the variable contracts.

Impose current taxation of inside buildup on newly issued life insurance contracts held by nonnatural persons

The inclusion in income of the inside buildup on newly issued life insurance policies could apply only to policies held by persons other than natural persons. This proposal would conform the treatment of the inside buildup on life insurance policies held by nonnatural persons with the treatment of the inside buildup on deferred annuity contracts held by such persons.

Limit amount of inside buildup that is not subject to current taxation

As an alternative to imposing current taxation on the entire amount of inside buildup, a limitation could be imposed on the amount of inside buildup for any taxable year that is not subject to tax. This limitation could be established at a level that would allow a policyholder to avoid current tax on the amount of inside buildup that would be credited on an ordinary life policy with the same death benefit or a policy with the same death benefit that provides for level premiums over a specified period, such as five or ten years.

A similar result could be achieved by imposing a limitation on the annual amount or aggregate lifetime amount that a policyholder could invest in life insurance contracts and annuity contracts on a tax-favored basis. Under this proposal, the inside buildup on amounts invested in excess of the limitation would be subject to current tax.

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[12] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 254-258.

Treat inside buildup as an item of preference under minimum tax

A more limited approach to imposing current taxation on inside buildup would be to treat all or a portion of the investment income on newly issued life insurance contracts as a preference item for purposes of the alternative minimum tax. Under this approach, a tax at the rate of 21 percent (20 percent in the case of corporations) would be imposed on a taxpayer subject to the minimum tax on the inside buildup on life insurance contracts that are identified as excessively investment-oriented or on inside buildup in excess of a permitted amount or rate.

2. Definition of life insurance

In general

The statutory definition of life insurance could be narrowed for newly issued life insurance policies to provide that significantly investment-oriented life insurance policies, such as single premium policies, would not be treated as life insurance for Federal income tax purposes. If a contract does not satisfy the statutory definition of life insurance, then the inside buildup under the contract for any taxable year would be treated as ordinary income received or accrued by the policyholder during the year. In addition, amounts received upon the death of the insured would be excluded from the income of the recipient only to the extent that the amount received exceeds the net surrender value of the contract.

Require increased insurance protection during 5 or 10 year period after issuance of contract

The statutory definition of life insurance could be modified to require increased insurance protection during the first 5 or 10 years after the issuance of the contract. One method of accomplishing this result is to limit the amount of premium payments during each of the first 5 (or 10) years after the issuance of the contract to an amount that equals one-fifth (or one-tenth) of the maximum single premium that is allowed under present law for the year the contract is issued.

Thus, under the cash value accumulation test, a contract would not be treated as a life insurance contract for Federal income tax purposes if the amount of the premium paid for any of the first 5 (or 10) years of the contract exceeds one-fifth (or one-tenth) of the net single premium for the benefits provided in the contract. Similarly, under the guideline premium requirements, a contract would not be treated as a life insurance contract for Federal income tax purposes if the amount of the premium paid for any of the first 5 (or 10) years of the contract exceeds one-fifth (or one-tenth) of the guideline single premium for the contract.

Under this premium limitation requirement, a reduction in the benefits under the contract during the first 5 (or 10) years after the issuance of the contract would require a recomputation of the single premium for each year preceding the reduction in benefits. In addition, rules may be necessary to address increased premium payments, reduced future benefits, and other similar modifications

to the contract that occur after the end of the 5-year (or 10-year) period.

Treatment of mortality charges and expense charges

A further modification to the definition of life insurance would be to determine the net single premium, guideline single premium, and guideline level premiums on the basis of the mortality charges actually charged to the policyholder or the mortality charges used in determining the statutory reserve for the contract rather than the mortality charges specified in the contract. It is understood that some insurance companies specify excessive mortality charges in a contract without actually charging the policyholder for such amounts in order to increase artificially the amount of the net single premium, guideline single premium, or guideline level premiums for the contract. This results in an increase in the allowable cash surrender value under the cash value accumulation test or an increase in the amount of premiums that may be paid under the guideline premium requirements.

In addition, restrictions could be imposed on the amount of expenses that are taken into account in applying the guideline premium requirements.[13] For example, expenses could be limited to 10 percent of the mortality charges actually charged to the policyholder or used in determining the statutory reserve for the contract.

The use of actual mortality charges (or the mortality charges used in determining the statutory reserve for a contract) and the restrictions on expense charges could apply for purposes of determining the limitation on premium payments during the first 5 (or 10) years of the contract and/or for purposes of applying the cash value accumulation test and the guideline premium requirements.[14] In either case, rules may be necessary to address inflated mortality or expense charges that are refunded to policyholders as a policyholder dividend.

Interest rates used in determining net single premium and guideline premiums

In determining the net single premium for purposes of the cash value accumulation test and the guideline premiums for purposes of the guideline premium requirement, the interest rate could be adjusted to equal the greater of (1) the applicable Federal rate ("AFR") in effect on the date that the contract is issued, or (2) the rate guaranteed on issuance of the contract. The AFR is currently used in calculating life insurance reserves, as well as for other interest imputation purposes.

Treatment of variable contracts

Any contract that provides a return that is based on the current investment return or current market value of a segregated asset

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[13] The expenses of issuing and maintaining a life insurance contract are not taken into account in determining the net single premium of the contract, and, consequently, such expenses do not affect the allowable cash surrender value under the cash value accumulation test.

[14] If the mortality charges used in determining the statutory reserve for a contract and the limitation on expense charges are required for purposes of applying the cash value accumulation test and the guideline premium requirements, the premium that could be charged for any life insurance contract would be statutorily capped.

account (i.e., a variable contract) could be excluded from the definition of life insurance. Alternatively, variable life insurance contracts could be excluded from the definition of life insurance if the policyholder is permitted to elect different investment options after the issuance of the contract.

GAO proposal relating to the treatment of loans in defining life insurance

In a recent report on the taxation of single premium life insurance, the General Accounting Office (GAO) suggested a change to the statutory definition of life insurance.[15] GAO proposed that the cash value corridor be modified for single premium contracts by reducing the amount of the death benefit by the amount of any loan outstanding under the contract. Because the minimum death benefit under a life insurance contract must exceed a specified percentage of the cash surrender value under the contract in order to satisfy the cash value corridor, the GAO proposal generally should limit the ability of policyholders to borrow against single premium contracts.[16]

3. Treatment of pre-death distributions from life insurance contracts

Description of H.R. 3441

H.R. 3441 (introduced by Messrs. Stark and Gradison on October 7, 1987) would alter the Federal income tax treatment of loans and other pre-death distributions from life insurance contracts to conform the treatment of distributions from life insurance contracts to the treatment of distributions from annuity contracts prior to the annuity starting date. Under the bill, distributions from life insurance contracts would be treated as income first and then recovery of basis.[17] In addition, loans under life insurance contracts (including pledges and assignments of contracts) would be treated as distributions that are subject to the new basis ordering rule.[18] Finally, an additional 10-percent income tax would be imposed on the portion of any distribution or loan under a life insurance contract that is includible in income. This early withdrawal tax would not apply if a distribution occurs (1) after the holder of the contract attains age 59-1/2; (2) on account of the holder's disability; or (3) as

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[15] United States General Accounting Office, Briefing Report to the Honorable Fortney H. (Pete) Stark, House of Representatives: *Tax Policy, Taxation of Single Premium Life Insurance* (GAO/GGD-88-9BR), October 1987. As an alternative to the change to the statutory definition of life insurance, GAO suggested that loans under single premium contracts be treated as distributions. This alternative is summarized below in "3. Treatment of pre-death distributions from life insurance contracts."

[16] The principal reason for this result is that the GAO proposal does not reduce the cash surrender value under the contract by the amount of the loan. Under present law, neither the cash surrender value nor the death benefit is reduced by policyholder loans in determining whether a contract falls within the cash value corridor.

[17] Policyholder dividends under newly issued life insurance contracts generally would be subject to the new basis recovery rule. An exception to the new rule would be provided for policyholder dividends that are retained by the insurance company as a premium or other consideration paid for the contract. This exception is consistent with the present-law treatment of policyholder dividends under annuity contracts.

[18] H.R. 3441 also provides that a transfer of an insurance contract for less than full value would be taxable under the same rule that currently applies to annuity contracts.

part of an annuity-type distribution over the holder's life expectancy.

H.R. 3441 would apply to loans and other pre-death distributions that occur after October 7, 1987 (the date of introduction of the bill), but only to the extent that the amount distributed is allocable to premiums paid on or after such date.

Limit application of H.R. 3441 to specific contracts

The provisions of H.R. 3441 could be limited to a specific class of contracts that are considered to be heavily investment oriented. For example, the reversal of the basis ordering rule, the treatment of loans as distributions, and the imposition of the early withdrawal tax could be limited to contracts under which the amount of premiums paid during any of the first 5 (or 10) years after the issuance of the contract exceed one-fifth (or one-tenth) of the maximum single premium allowed under present law. Alternatively, the stricter distributional rules could apply to a specific class of investment-oriented contracts for a limited period of time after the issuance of any such contract.

GAO proposal relating to the treatment of loans as distributions

In its recent report on the taxation of single premium life insurance,[19] GAO suggested that policyholder loans be treated in the same manner as distributions under annuity contracts. Thus, the amount of a policyholder loan would be includible in gross income to the extent that the cash surrender value of the contract immediately before the loan exceeds the investment in the contract at such time. It is unclear whether the GAO alternative would change the basis ordering rule for other pre-death distributions from life insurance contracts.[20]

Other possible proposals relating to loans and partial surrenders

The treatment of policyholder loans and partial surrenders under H.R. 3441 would be consistent with the treatment of loans and partial surrenders under annuity contracts. As an alternative, loans and partial surrenders under life insurance contracts could be treated in the same manner as loans and early distributions from qualified pension, profit-sharing, or stock bonus plans.

Under present law, a loan from a qualified pension, profit-sharing, or stock bonus plan generally is treated as a taxable distribution from the plan to the extent that (1) the loan exceeds a specified amount (the lesser of $50,000 or one-half of the participant's accrued benefit) or (2) the time for repayment exceeds 5 years. In the case of a pre-annuity starting date distribution from a qualified pension, profit-sharing, or stock bonus plan, part of the distribution is considered basis recovery and the remainder is income.

Policyholder loans could alternatively be treated as below-market loans that are subject to the rules of section 7872. Under this proposal, the policyholder would be treated as (1) paying a market rate

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[19] *See* note 15, *supra.*

[20] The GAO proposal indicates that if policyholder loans are treated in the same manner as distributions under annuity contracts, loans or *distributions from income* would be treated as taxable income in the year withdrawn. *Id.* at 30.

of interest on the loan to the insurance company, and (2) receiving a dividend from the insurance company equal to the amount of deemed interest.[21]

Finally, additional restrictions could be imposed on the deductibility of interest on indebtedness that is incurred with respect to life insurance policies. For example, interest on indebtedness that is incurred with respect to life insurance contracts could be treated as nondeductible (as is the case for interest on indebtedness that is incurred or continued to purchase or carry tax-exempt obligations). Alternatively, the present-law limit on the deductibility of interest in the case of indebtedness exceeding $50,000 per officer or employee of, or person financially interested in, any trade or business carried on by the taxpayer could be decreased or an overall cap (in addition to the present limit) could be placed on the amount of deductible interest or allowable indebtedness.

Reduction of investment in contract by cost of term insurance

As proposed by the President in his tax reform proposals of 1985,[22] a policyholder's basis (or investment in a contract) could be reduced by the aggregate cost of renewable term insurance provided under the contract. Consequently, under this proposal, policyholders would be unable to obtain the equivalent of a deduction for the cost of current insurance protection, which is generally regarded as a personal expense.[23]

4. Combination of definitional and distributional approaches

A combination of the definitional and distributional approaches could also be applied. Under this alternative, contracts that are considered abusive would not qualify as life insurance and, thus, the inside buildup would be taxed currently to the policyholder. Contracts that are not considered abusive but are considered excessively investment oriented would be subject to stricter distributional rules, such as basis reordering, the treatment of loans as distributions, and the 10-percent additional income tax. All other contracts would continue to be governed by present law.

B. Insurance Company Proposals

The use of life insurance as an investment vehicle could also be curtailed by changing the tax treatment of life insurance companies. Under present law, the amount of the reserve for any life insurance contract may not be less than the amount credited to the cash value of the contract. Because a life insurance company is allowed a deduction for increases in reserves, the life insurance company is not subject to tax on the inside buildup that is credited to the policy.

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[21] Absent a change in the basis ordering rule, this alternative would have minimal effect on the use of policyholder loans because the deemed policyholder dividend would not be includible in income by the policyholder unless the dividend exceeded the policyholder's investment in the contract.

[22] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), pp. 254-258.

[23] In determining the amount of any loss from the complete surrender of a life insurance contract, the cost of insurance protection is not included in basis. *London Shoe Co., Inc.*, 80 F.2d 230 (2nd Cir. 1935); *Century Wood Preserving Co.*, 69 F.2d 967 (3rd Cir. 1934).

Treatment of reserves

One method of addressing this issue at the life insurance company level (as opposed to the policyholder level) would be to deny the insurance company a reserve deduction for all newly issued life insurance contracts. Under this proposal, an insurance company would be allowed a deduction for death benefits only as the benefits are actually paid. Thus, the investment income on life insurance contracts would be subject to current tax at the life insurance company level.

Alternatively, a portion of the inside buildup on investment-oriented contracts could be taxed to the insurance company by limiting the reserve for any contract to the amount of the reserve that would be allowed for a contract with the same death benefit if the contract was funded on a level basis over a specified period, such as 5 or 10 years. Similarly, the provision of a loan could be taxed to the insurance company by requiring the insurance company to reduce its reserve for any contract by the amount of any loan outstanding under the contract.

Alternative minimum tax treatment

Another approach would be to disallow deductions for life insurance reserves in computing the corporate minimum tax. Under this approach, reserve deductions for newly issued policies would not be permitted in calculating an insurance company's alternative minimum taxable income, with the result that the inside buildup on those policies issued by an insurance company subject to the minimum tax would be subject to tax at the corporate alternative minimum tax rate of 20 percent.

Definitional approach to life insurance reserves

The present law definition of life insurance (or a modified version of it) could be applied at the insurance company level. That is, no reserve would be permitted with respect to a contract that fails to meet the definition of life insurance.

V. ANALYSIS OF PROPOSALS TO RESTRICT THE USE OF LIFE INSURANCE AS AN INVESTMENT VEHICLE

Taxation of inside buildup

The proposal to tax the inside buildup on all newly issued life insurance contracts is considered by many to be an overly broad approach to limiting the use of life insurance as an investment vehicle. Under such an approach, ordinary life insurance and other extended premium payment policies would be subject to current tax, although historically these policies have not been purchased for the purpose of sheltering investment earnings. It is argued that the taxation of the inside buildup on all life insurance contracts would significantly reduce the amount of life insurance that is purchased and, thus, many dependents would be left with an inadequate source of income upon the death of the insured.

On the other hand, it may be considered appropriate to tax the inside buildup if the insurance is not purchased for the purpose of providing death benefits for dependents after the death of the insured, regardless of the rate of premium payments under the contract. For example, many corporations and other businesses purchase life insurance on the lives of employees solely as a tax-free or tax-deferred investment to fund liabilities under nonqualified deferred compensation plans or other similar liabilities. The ability of taxpayers to use life insurance to fund liabilities arising under nonqualified deferred compensation plans creates a disincentive to establish qualified plans, which under present-law nondiscrimination rules must cover rank-and-file employees in addition to officers and other highly-compensated employees.

Further, if it is determined that the purchase of whole life insurance should be encouraged by providing favorable treatment of the inside buildup, but that such treatment should not be available for higher-income taxpayers who use life insurance as a tax-sheltered investment, it may be appropriate to impose an annual or lifetime cap on the amount that may be invested in life insurance and deferred annuity contracts on a tax-favored basis. Alternatively, including the inside buildup on life insurance as an item of tax preference for purposes of the alternative minimum tax also would restrict the ability of higher-income taxpayers to shelter investment earnings without adversely affecting other taxpayers.

Definition of life insurance

The principal argument in support of proposals to modify the present-law definition of life insurance to require increased insurance protection during the initial years of a life insurance contract is that such proposals affect life insurance contracts that are considered to be overly investment-oriented, rather than affecting all life insurance contracts. In addition, a modification to the defini-

tion of life insurance that reduces the amount of the premium that is available for investment purposes is likely to discourage the sale of life insurance as a tax-sheltered investment rather than as a means to provide death benefits.

On the other hand, the definitional approach may be more complex than the other alternatives and may be susceptible to manipulation. For example, the present-law cash value accumulation test and the guideline premium requirements have been manipulated by life insurance companies through the use of inflated mortality and expense charges that are never actually charged to the policyholder. Even if it is determined that increased insurance protection need not be required during the initial years of an insurance contract, it may be appropriate to tighten the present-law definition of life insurance to address inflated mortality and expense charges.

Treatment of pre-death distributions

Proposals for the reversal of the basis ordering rules, the treatment of loans as distributions, or the imposition of a 10-percent early withdrawal tax for certain pre-death distributions under life insurance contracts may be subject to criticism for inadequately targeting policies that are overly investment oriented. It is contended by some that present law should continue to apply with respect to insurance contracts that provide a significant amount of insurance protection. Based on this argument, only those contracts that are defined as overly investment oriented would be subject to the stricter distribution rules.

Other opponents contend that the distributional approach would not curtail the sale of single premium and other heavily investment-oriented life insurance contracts because there is a significant tax advantage in the compounding of investment earnings on a tax-free basis that would not be recaptured if the distribution occurs a significant period of time after the issuance of the contract. Instead, it is believed that the focus should be on the amount of money that may be allocated to the cash value of a life insurance contract in relation to the amount of insurance protection provided under the contract.

Those opposing changes to the treatment of loans under life insurance contracts argue that policyholder loans should not be treated differently from other loans secured by property that has appreciated in value. For example, a taxpayer is not treated as realizing gain on a house that has appreciated in value if the taxpayer borrows money using the equity in the house as collateral for the loan.

The principal argument in favor of the distributional approach is that it would prevent policyholders from gaining ready access to tax-free investment income and, thus, the distributional approach should ensure that life insurance contracts are being purchased to provide death benefits for dependents rather than for other financial purposes. In addition, the distributional approach generally is consistent with the present-law treatment of distributions from qualified pension plans and annuity contracts. If the distribution rules applicable to life insurance remain more favorable than the rules applicable to qualified pension plans, employers will continue

to have an incentive to establish nonqualified deferred compensation plans that cover only highly compensated employees.

Treatment of life insurance companies

It can be argued that the taxation of life insurance companies on the inside buildup on life insurance contracts is likely to be more administrable than taxing the policyholders directly. In addition, such an approach ensures that the inside buildup does not completely escape income taxation, which ordinarily occurs if a life insurance policy is held until the death of the insured.

On the other hand, the taxation of life insurance companies on inside buildup is inconsistent with the Federal income tax treatment of other financial intermediaries, such as banks, mutual funds, and real estate investment trusts. Under present law, financial intermediaries generally are not required to include in taxable income the amount of investment earnings that are credited or otherwise set apart for their customers. These investment earnings, however, generally are taxable to the customers of the financial intermediaries for the taxable year in which credited or otherwise set apart.

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